

REPORT OF EXAMINATION
OF THE
FIRE INSURANCE EXCHANGE

AS OF
DECEMBER 31, 2006

Participating State
and Zone:

California

Filed June 23, 2008

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Los Angeles, California
June 23, 2008

Honorable Alfred W. Gross
Chairman of the NAIC Financial
Condition Subcommittee
Commissioner of Insurance
Virginia Bureau of Insurance
Richmond, Virginia

Honorable Morris Chavez
Secretary, **Zone IV-Western**
Superintendent of Insurance
New Mexico Insurance Division
Santa Fe, New Mexico

Honorable Steve Poizner
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Chairman, Secretary and Commissioner:

Pursuant to your instructions, an examination was made of the

FIRE INSURANCE EXCHANGE

(hereinafter also referred to as the Exchange or FIRE) at its home office located at 4680 Wilshire Boulevard, Los Angeles, California 90010.

SCOPE OF EXAMINATION

The previous examination of FIRE was made as of December 31, 2003. This examination covers the period from January 1, 2004 through December 31, 2006. The examination was made pursuant to the National Association of Insurance Commissioners' plan of examination. The examination included a review of FIRE's practices and procedures, an examination of management records, tests and analyses of detailed transactions, and an evaluation of the assets and a determination of liabilities as of December 31, 2006, as deemed necessary under the circumstances.

This examination was conducted concurrently with examinations of FIRE's California subsidiaries and affiliates, namely: Farmers Insurance Exchange, Truck Insurance Exchange, Mid-Century

Insurance Company, Civic Property and Casualty Company, Exact Property and Casualty Company, Neighborhood Spirit Property and Casualty Company, and Farmers Reinsurance Company.

In addition to those items specifically commented upon in this report, other phases of FIRE's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of exchange; business in force by states; loss experience; accounts and records; and sales and advertising.

SUBSEQUENT EVENTS

Bristol West Holdings, Inc.

On July 3, 2007, Farmers Group, Inc. (FGI), the attorney-in-fact for the three exchanges, completed the acquisition of Bristol West Holdings, Inc. (BWH), a Delaware corporation, including its two directly-owned insurance company subsidiaries; Security National Insurance Company, a Florida company, Bristol West Preferred Insurance Company, a Michigan company, and certain insurance services companies. Also included in the acquisition were BWH's directly owned insurance holding company; Coast National Holding Company, a California company, and its insurance company subsidiary Coast National Insurance Company (CNIC), a California company which in turn owned Bristol West Insurance Company, an Ohio company, and Bristol West Casualty Insurance Company, an Ohio company.

BWH, via its insurance subsidiaries, had licenses in 38 states plus the District of Columbia, operated in 22 states and was a provider of liability and physical damage insurance, specializing in non-standard private passenger auto.

FGI paid \$713.5 million plus the assumption of \$100 million of debt obligations for BWH. Additional consideration for the transaction included the commutation of certain existing affiliated reinsurance arrangements between BWH's insurance subsidiaries, and the execution of a 90% quota

share cession agreement between CNIC and Farmers Insurance Exchange to be effective January 1, 2007. The CNIC quota share agreement was approved by the California Department of Insurance (CDI) on June 29, 2007.

The above transactions resulted in changes in the ultimate control of BWH's subsidiary, CNIC. FIE and Zurich Financial Services (ZFS), a Swiss company and FGI's ultimate parent corporation, filed a joint Form A application pursuant to California Insurance Code (CIC) Section 1215.2. Additionally, Form D applications were filed pursuant to CIC Section 1215.5. On June 28, 2007, FIRE received correspondence from CDI that the transactions were "not disapproved".

Concurrent with the acquisition, FGI sold BWH's underlying insurance business to FIRE, Farmers Insurance Exchange (FIE), Truck Insurance Exchange (Truck), and Mid-Century Insurance Company (Mid-Century) for \$420 million, which represented an equity value of \$370 million plus \$50 million of debt assumption. In addition, FIRE, FIE, Truck, and Mid-Century incurred transaction fees of \$13.8 million. FGI retained certain of BWH's employees, the operational systems, and the management servicing rights. The acquisition was recorded using the statutory purchase method of accounting. The following schedule depicts each exchange/company's share of the costs, fees and goodwill for the acquisition of the BWH insurance business:

| (in millions) | | | |
|-------------------------------|----------------------|-----------------|-------------------|
| <u>Entity</u> | <u>Cost and Fees</u> | <u>Goodwill</u> | <u>Percentage</u> |
| Farmers Insurance Exchange | \$162.7 | \$38.2 | 37.50% |
| Truck Insurance Exchange | 38.0 | 8.9 | 8.75% |
| Fire Insurance Exchange | 16.3 | 3.8 | 3.75% |
| Mid-Century Insurance Company | <u>216.8</u> | <u>51.0</u> | <u>50.00%</u> |
| Totals | <u>\$433.8</u> | <u>\$101.9</u> | <u>100.00%</u> |

On May 8, 2008, the intermediate-level holding structure was re-organized and FGI is now currently owned 87.9% by Zurich Insurance Company (ZIC), 10.375% by Zurich Group Holdings (ZGH), and

1.725% by three Partnerships (Zurich RegCaPS II, V, VI) having ZIC as the General Partner and ZGH as the Limited Partner. ZFS continues to be the ultimate controlling party.

FIRE HISTORY

FIRE was incorporated in California on November 10, 1942, for the purpose of conducting property and casualty insurance.

A significant portion of FIRE stated surplus as regards policyholders at the examination date was composed of surplus notes (issued to non-affiliates), and contribution certificates (issued to affiliates). The following schedule depicts the specific issuances and amounts outstanding at December 31, 2006:

| <u>Date issued</u> | <u>Interest Rate</u> | <u>Par Value</u> | <u>Maturity Date</u> |
|--------------------|----------------------|----------------------|----------------------|
| 12/22/1958 | 4.000% | \$ 1,130,000 | Conditional |
| 12/27/1962 | 4.000% | 200,000 | Conditional |
| 12/19/1963 | 4.500% | 250,000 | Conditional |
| 12/04/1964 | 4.500% | 250,000 | Conditional |
| 12/27/1966 | 6.000% | 500,000 | Conditional |
| 12/29/1967 | 6.000% | 500,000 | Conditional |
| 12/31/1969 | 8.500% | 500,000 | Conditional |
| 06/30/1984 | variable | 20,000,000 | Conditional |
| 07/10/1998 | 7.050% | 53,846,000 | 07/15/2028 |
| 07/10/1998 | 7.200% | 16,154,000 | 07/15/2048 |
| 06/21/2004 | 6.150% | <u>107,000,000</u> | 12/31/2013 |
| Total | | <u>\$200,330,000</u> | |

The aforementioned notes and certificates have restrictions, which require the approval of the California Department of Insurance (CDI) before payment of interest and principal. Interest can be

paid out of earned (unassigned) surplus only. The payments of interest and repayments of principal, occurring during this examination period were made with the approvals of the CDI.

The above eight contribution certificates, transacted between 1958 and 1984, were issued to Fire Underwriters Association (FUA), FIRE's attorney-in-fact.

The above trust surplus notes, transacted on July 10, 1998, were issued to qualified institutional buyers in the open market and are administered by Chase Manhattan.

On June 21, 2004, a new certificate of contribution in the amount of \$107,000,000 was issued in consideration for the surrender and discharge of two earlier certificates issued on March 7, 2000, and December 31, 2001 to FUA in the same total amount, but then assigned by FUA to Zurich Capital Markets, Inc (ZCM) on January 30, 2004. On July 28, 2004, the new certificate was assigned by ZCM to Zurich Investments LLC, a Luxembourg company.

Foremost Corporation of America

In October 1999, Spartan Parent Corporation (Spartan), a jointly-owned subsidiary of FIRE, Farmers Insurance Exchange (FIE) and Truck Insurance Exchange (Truck), entered into an agreement to acquire Foremost Corporation of America (Foremost Corp.) for \$812 million. Foremost Corp. owned Foremost Insurance Company of Grand Rapids, Michigan (Foremost I.C.), which predominately wrote recreational vehicle and mobile home policies. The three exchanges gave notices of the investment to the CDI under California Insurance Code Section 1215.5(b)(1). In March of 2000, the Foremost Corp. acquisition was finalized.

Effective at the time of acquisition, Spartan was merged with and into Foremost Corp. and its outstanding common stock interest in Foremost Corp. was redistributed to the aforementioned three exchanges. The exchanges accounted for the acquisition using the statutory purchase method of

accounting. FIRE's equity ownership of Foremost Corp. is 10%, with sister exchanges FIE owning 80% and Truck owning 10%.

The three exchanges each reported their investments in Foremost Corp. as two separate and distinct investments. The investment in Foremost Corp. was reported at GAAP equity value plus the remaining goodwill balance (after amortization) less the non-admissible portion of goodwill pursuant to the National Association of Insurance Commissioners' Statement of Statutory Accounting Principles. The investment in Foremost I.C. was reported at the statutory equity value indicated in the Foremost I.C. Statutory Annual Statement.

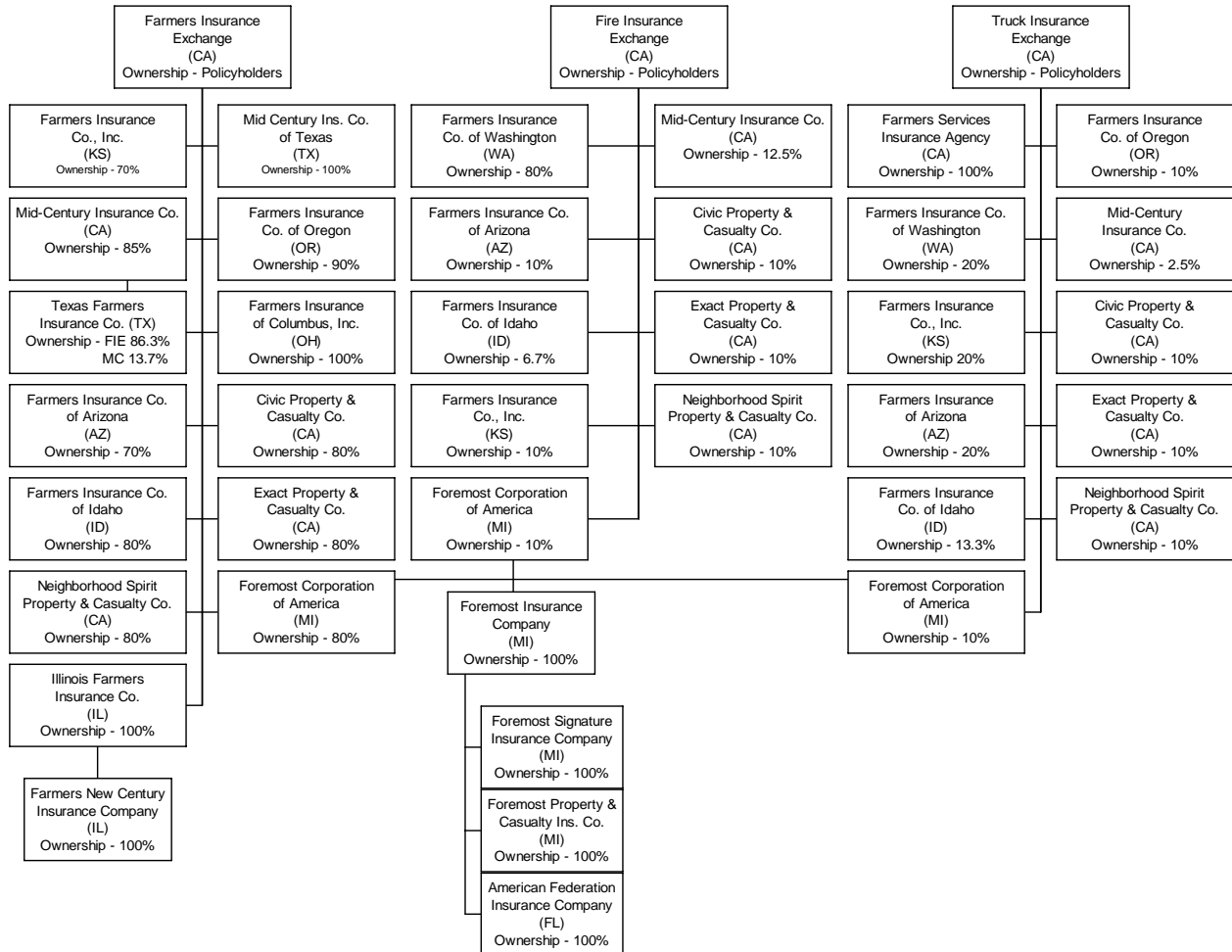
MANAGEMENT AND CONTROL

FIRE, a reciprocal insurer organized under California Insurance Code (CIC) Section 1300 et. seq. was controlled by its attorney-in-fact, Farmers Group, Inc. (FGI), dba Fire Underwriters Association. FGI is a U.S. subsidiary of Zurich Financial Services, a Swiss holding company.

The following abridged organizational charts show the relationship of FIRE to its affiliates as of December 31, 2006 and subsequent to the acquisition of Bristol West Holdings, Inc.:

FARMERS EXCHANGES

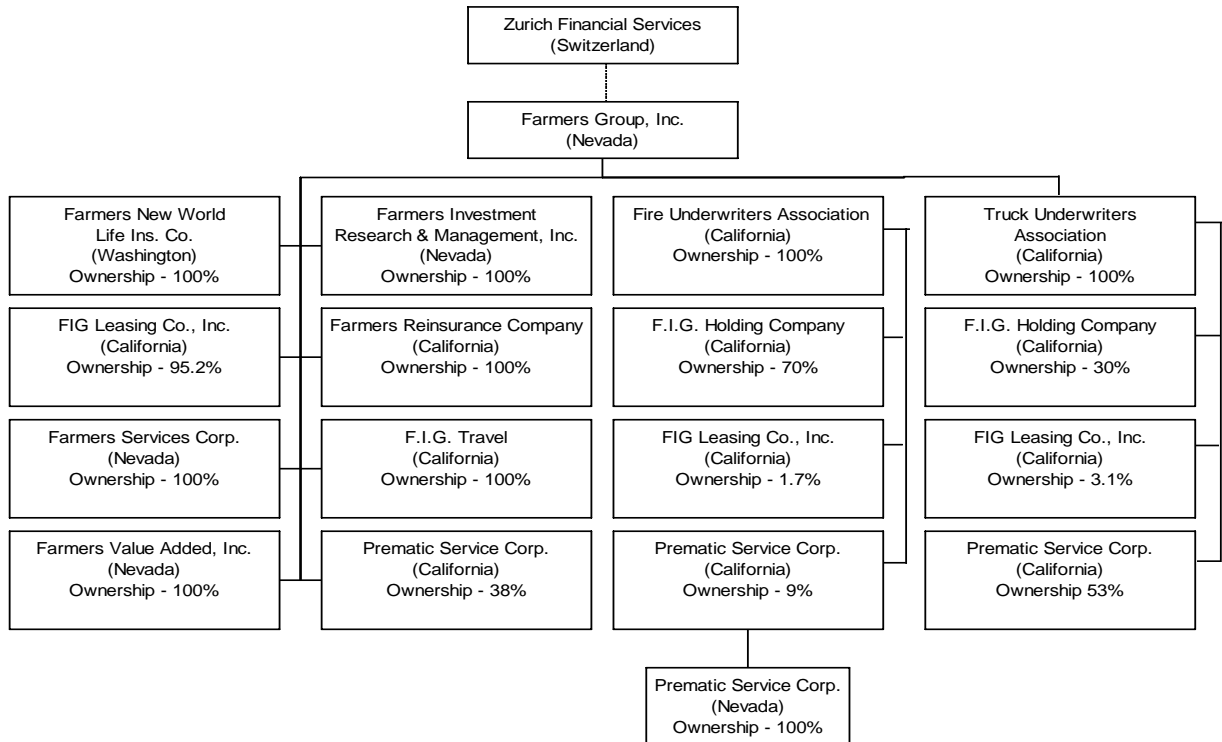
December 31, 2006



(*) all ownership is 100% unless otherwise noted.

ZURICH FINANCIAL SERVICES GROUP

December 31, 2006

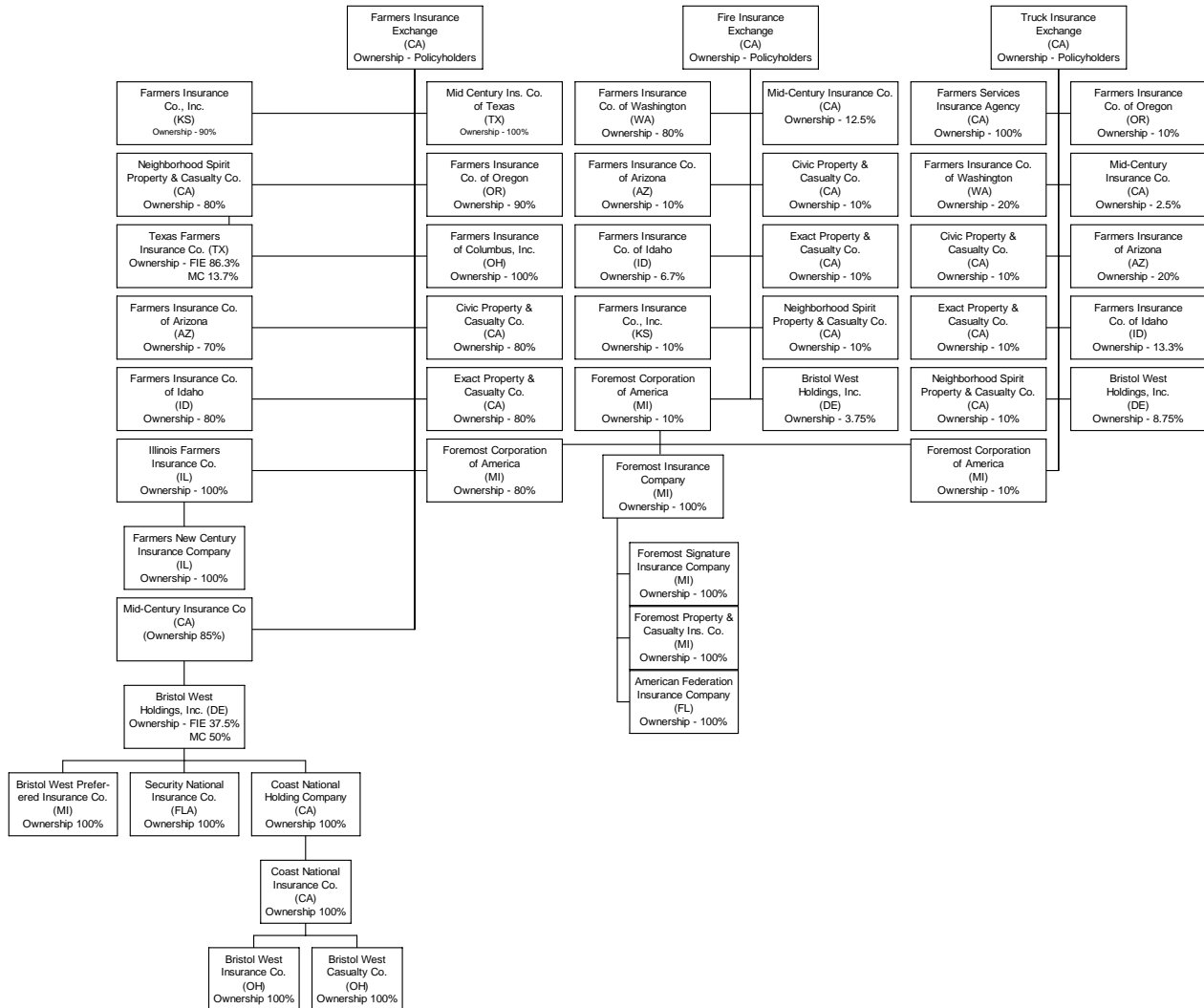


(*) all ownership is 100% unless otherwise noted.

Note: FIRE operates through Farmers Insurance Group, Inc. (FGI) under a separate dba: Fire Underwriters Association.

FARMERS EXCHANGES

DECEMBER 31, 2007



(*) all ownership is 100% unless otherwise noted.

Management of FIRE was vested in a twelve (12) member board of governors, elected annually. A listing of the members of the board and principal officers serving on December 31, 2006 follows:

Board of Governors

| <u>Name and Residence</u> | <u>Principal Business Affiliation</u> |
|---|--|
| Gisselle Acevedo-Franco Monrovia, California | Director Non-profit organization |
| William Haskell Braddock Surprise, Arizona | Retired |
| James Ellwood Hansen Corona, California | Retired |
| Peter David Kaplan Los Angeles, California | President Academy Award Cloths, Inc. |
| Frederick Henry Kruse Lake Ozark, Missouri | Banking and financial services |
| Dale Ann Marlin Newport Beach, California | Computer consultant |
| Gary Alan McCarter Huntley, Illinois | Retired |
| Kathleen Leavey McCarthy Los Angeles, California | Trustee Leavey Foundation |
| Gerald Alden McElroy La Quinta, California | Managing Director Gerald A. McElroy & Associates, LLP |
| Roger Lee Persons Palmdale, California | Owner and Director Chapel of the Valley Mortuary |
| Taylor Lane Stephens Fort Collins, Colorado | Consultant |
| Richard Lewis Wells | Retired |

Board of Governors

Name and Residence

Principal Business Affiliation

Lake Ozark, Missouri

Principal Officers

Name

Title

| | |
|---------------------------------|------------------------------|
| Frank Robert Woudstra | President |
| Ronald Gregory Myhan | Vice President and Treasurer |
| Doren Eugene Hohl | Secretary |
| Paul Norman Hopkins | Vice President |
| Jason Lawrence Katz | Vice President |
| Kevin Eugene Kelso | Vice President |
| Bryan Francis Murphy | Vice President |
| Mhayse Gokul Samalya | Vice President |
| Keitha Tullos Schofield | Vice President |
| Stanley Ray Smith | Vice President |
| Lonnie Alan Sproat | Vice President |
| Warren Benjamin Tucker (*) | Vice President |
| Pierre Christophe Wauthier (**) | Vice President |

(*) Resigned on May 31, 2007 and replaced by James Leslie Nutting on June 1, 2007.

(**) Resigned on October 1, 2007 and was replaced by Scott Lundquist February 11, 2008.

Management Agreements

Farmers Group, Inc. (FGI), the Attorney-In-Fact, provides all operating services (including staffing and occupancy) except claims adjustment services to FIRE. These services were provided to FIRE pursuant to the subscription agreements signed by each individual policyholder of FIRE. There was no specific management services agreement required between FIRE and FGI for the aforementioned services provided. California Insurance Code (CIC) Section 1215.4 and Section 1215.5 provides for an exemption from reporting for an inter-insurance exchange utilizing the subscription agreements providing that the “form of this agreement was in place prior to 1943 and it was not amended in any

way to modify payments, fees, or waivers of fees or otherwise substantially amended after 1943". For 2004, 2005, and 2006, fees paid by FIRE to FGI for such services were \$116,444,520, \$118,185,633, and \$121,020,482, respectively.

FIRE is responsible for the payment of claims (adjustment function), payment of commissions and the payment of premium and income taxes.

Claims Adjustment Services Arrangement

Farmers Insurance Exchange (FIE) staffs a claims department for the adjustment of its own claims and to adjust certain of its affiliated insurance companies' claims, including FIRE's. The claims adjustment services arrangement in place between FIE and certain of its affiliates (the pooled companies including FIRE), with FIE providing all of their claims adjustment services, was not written. During 2004, 2005, and 2006, net claims adjustment service fees paid by FIRE to FIE as a result of its participation in the intercompany reinsurance agreement were \$65,158,000, \$62,659,000, and \$65,415,000, respectively.

Managed Care Services Agreement

Fire is a party to a managed care services agreement, effective October 1, 1998, with Zurich Services Corporation (ZSC), an affiliate. ZSC provides certain bill review and medical management services for FIRE's workers' compensation claims. It is recommended that FIRE submit this managed care services agreement to the California Department of Insurance (CDI) pursuant to CIC Section 1215.5 for approval.

Tax Sharing Agreement

FIRE's federal income tax return was consolidated with an affiliate, Farmers Insurance Company of Washington. There was a written tax sharing agreement in place effective May 1, 1995. The tax allocation was based on separate return calculations with current credit for net losses. FIRE's portion

of the federal income taxes recovered for 2004, 2005, and 2006, was (\$6,989,156), (\$5,679,267), and (\$7,444,000), respectively.

Investment Management Agreements

FGI, acting on behalf of FIRE, FIE, Truck Insurance Exchange (Truck) and the subsidiaries of these three exchanges, entered into an Investment Management Agreement dated July 1, 1998 with its affiliate, Scudder Kemper Investments Inc. (Scudder). In 2002, Scudder was acquired and replaced by Deutsche Asset Management (DeAM), a division of Deutsche Bank, AG. DeAM, a non-affiliate, managed FIRE, FIE, Truck and the subsidiaries' fixed income and equity asset portfolios. The terms of the Investment Management Agreement have otherwise not been altered.

FGI was also a party to the Service Level Agreement dated November 4, 1998 with Scudder, which was replaced in 2002 by DeAM. DeAM, a non-affiliate, provided accounting and reporting services in connection with FIRE, FIE, Truck and the stock subsidiaries' investment portfolios, including Securities Valuation Office reporting. DeAM was given the authority to vote the proxies of the common stock. The terms of the Service Level Agreement were left unchanged except for the replacement of parties.

Securities Lending Agreement

In 1999 FIRE filed with the CDI a proposed securities lending agreement with its affiliate, Zurich Capital Markets Trust Company (Zurich).

In December 2001, FIRE changed its securities lending agent from Zurich to the Bank of New York Western Trust (BNY), a non-affiliate, as Zurich had decided to exit the securities lending business. "Collateral" as defined in the securities lending agreement between BNY and FIRE indicated government securities and cash. The agreement also stipulated that BNY establish a "custodial custody account" in the name of FIRE for the purpose of holding collateral and approved investments

pertaining to securities lending transactions. The custodian was Wall Street Portfolio Advisors, a division of BNY. The current agreement conformed to the securities lending limits specified in the CDI Bulletin 82-2.

TERRITORY AND PLAN OF OPERATION

FIRE is licensed in the following 31 states:

| | | |
|------------|---------------|--------------|
| Alabama | Kansas | Ohio |
| Arizona | Michigan | Oklahoma |
| Arkansas | Minnesota | Oregon |
| California | Missouri | South Dakota |
| Colorado | Montana | Texas |
| Florida | Nebraska | Utah |
| Georgia | Nevada | Washington |
| Idaho | New Hampshire | Wisconsin |
| Illinois | New Jersey | Wyoming |
| Indiana | New Mexico | |
| Iowa | North Dakota | |

Major Lines of Business:

Principally, FIRE directly writes homeowners multiple peril business. However, Farmers Insurance Exchange (FIE), and its pooled subsidiaries and affiliates, writes most of the property and casualty lines of business with a heavy emphasis on personal lines. The principal lines written or assumed by FIRE from FIE (the lead pooling company in the pooling arrangement) were private passenger auto liability, auto physical damage, and homeowners multiple peril. By volume, commercial multiple peril is the more material commercial line that was directly written by FIRE.

In 2006, FIRE wrote \$2 billion of direct premiums. Of the direct premiums written, \$1.2 billion (60%) was written in California, \$207.7 million (10.4%) was written in Texas, \$176.7 million (8.8%) was written in Colorado, and \$415.6 million (20.8%) was written in the remaining states.

Personal and commercial business is produced for the Farmers property and casualty companies (including FIRE) by an exclusive agency force of more than 18,000 agents and was supported by 30 state executive offices, 12 personal and commercial service centers, and 150 branch claim offices.

Approximately one-half of the Farmers property and casualty companies' business continues to be concentrated within the states of California and Texas. However, in recent years, the Farmers property and casualty companies have been expanding market presence eastward.

The Farmers property and casualty companies announced, during the fall of 2003, that they were fully withdrawing from the writing of the Medical Malpractice line of business. Policies then-existing were runoff.

FIRE and Truck operate through Farmers Group, Inc. (FGI) under separate dba's: Fire Underwriters Association and Truck Underwriters Association, respectively. FIE also operates directly through FGI, which functions as the attorney-in-fact with a dba of Farmers Underwriters Association.

REINSURANCE

Intercompany Reinsurance Pooling Agreement

FIRE and certain other members of the Farmers property and casualty companies, participated in an intercompany reinsurance pooling agreement. Under this agreement, the affiliated participants including FIRE ceded all of their business, net of all reinsurance, to the Farmers Insurance Exchange (FIE) acting as the lead company. FIE then retroceded a share of the business back to certain participants based on percentages prescribed under the pooling agreement. The most recent amendment to this long-standing agreement was approved by the California Department of Insurance (CDI) on January 12, 1999.

The participants in the intercompany reinsurance pooling agreement, and their respective participation percentages as of December 31, 2006, were as follows:

| <u>Pool Participant</u> | <u>Percentage</u> |
|---|-------------------|
| Farmers Insurance Exchange | 51.75 |
| Truck Insurance Exchange | 7.75 |
| Fire Insurance Exchange | 7.50 |
| Farmers Insurance Company of Oregon | 7.00 |
| Farmers Insurance Company of Washington | 2.00 |
| Mid-Century Insurance Company | 16.00 |
| Texas Farmers Insurance Company | 1.00 |
| Farmers Insurance Company, Inc. | 0.75 |
| Illinois Farmers Insurance Company | 0.75 |
| Farmers New Century Insurance Company | 0.75 |
| Farmers Insurance Company of Idaho | 0.75 |
| Farmers Insurance of Columbus, Inc. | 1.00 |
| Civic Property and Casualty Company | 1.00 |
| Exact Property and Casualty Company | 1.00 |
| Neighborhood Spirit Property and Casualty Company | <u>1.00</u> |
| Total | <u>100.00</u> |

Assumed

FIE maintained fronting arrangements (the so-called “RAS” treaties, which were historically long-standing reinsurance agreements with affiliates initiated between 1950 and 1995) by which all of the property business it wrote was ceded “prior to the inter-company pooling” to FIRE. Similarly, all of FIE’s workers’ compensation, medical malpractice, and commercial lines business was ceded to Truck Insurance Exchange (Truck) via the RAS agreements. FIE then retroceded the remaining business of the Farmers property and casualty companies to the insurers participating in the intercompany reinsurance pooling agreement according to their respective participation percentages. Mid-Century Insurance Company also fronted for FIRE in situations where a stock insurer was required.

Ceded

Affiliated

Treaties ceding quota share risks to affiliated reinsurers were written with FIE and all of its subsidiaries and affiliates (including FIRE) as the cedents and remained in effect at December 31, 2006. Included was an auto physical damage (APD agreement) 100% quota share agreement with several participants including the affiliated Zurich Insurance Company (Zurich) with an initial 65% participation and the affiliated Farmers Reinsurance Company (Farmers Re) with a 10% participation. Several non-affiliated reinsurers assumed the remaining 25% in participation. The premium for this APD agreement since 2001 was \$2 billion annually. The APD agreement was approved by the CDI in 2001 for one year, with one-year extensions granted in 2002 and 2003. In 2004, the APD agreement was revised to reduce the quota share percentage to 50%, with Zurich assuming a 40% participation and Farmers Re assuming the remaining 10% participation. Effective January 1, 2006, the above amended APD agreement was replaced by a new APD 100% quota share agreement. The premium for this replacement APD agreement was \$1 billion annually with Zurich assuming an 80% participation and Farmers Re assuming a 20% participation. The CDI approved this agreement on December 28, 2005.

On December 31, 2002, FIRE and its property and casualty subsidiaries and affiliated exchanges (including FIE) entered into a 10% “all-lines” quota share reinsurance agreement ceding business to Zurich and Farmers Re. This agreement covered all lines directly written, assumed from affiliates, or assumed from pools, associations, or syndicates. This agreement was then amended, effective December 31, 2004, to increase the percentage to 12% and amended again effective December 31, 2005, to decrease the percentage down to 6% (Zurich 4.8% participation and Farmers Re 1.2% participation) which was the cession at the examination date. The CDI approved this 2005 amendment on December 28, 2005. Subsequently, the agreement was amended effective December 31, 2007 to decrease the percentage to 5% (Zurich 4% participation and Farmers Re 1% participation)

and extend the duration to December 31, 2010. This latest amendment was approved by the CDI on December 28, 2007.

Ceded

Non-affiliated

Treaties ceding risks to non-affiliated reinsurers were written with FIRE and its sister exchanges (FIE and Truck) as the cedents. The following is a summary of the principal non-affiliated ceded excess of loss reinsurance treaties inforce as of December 31, 2006:

| Type of Contract | Reinsurer's Name | Company's Retention | Reinsurer's Maximum Limits |
|---|--|--|--|
| Property Catastrophe Excess of Loss – 1 st Layer | Lloyds of London (26.62%) Various reinsurers (63.38%) | \$200 million per occurrence | 90% of \$450 million excess of \$200 million retention each and every loss occurrence. Terrorism excluded |
| Property Catastrophe Excess of Loss – 2 nd Layer | Various reinsurers (90%) | \$650 million per occurrence | 90% of \$300 million excess of \$650 million retention each and every loss occurrence. Terrorism excluded. For Texas only, this layer is in excess of the \$500 million excess of \$650 million layer immediately below. |
| Property Catastrophe Excess of Loss – Texas | Lloyds of London (22.93%) Various reinsurers (76.07%) | \$650 million per occurrence | 99% of \$500 million excess of \$650 million, Texas only. Terrorism excluded (Property CAT Excess of Loss treaty above covers resulting loss corridor – resulting in Company net retention of \$200 million.). |
| Multi-Event Property Catastrophe Excess of Loss | Lloyds of London (32.74%) Various reinsurers (57.26%) | \$20 million per event plus a \$360 million aggregate deductible | 90% of \$180 million excess of \$20 million. Excludes California earthquake, Florida hurricane, mold, and terrorism. |
| Property Per Risk Excess of Loss – 1 st Layer | Lloyds of London (48.28%) | \$3 million each and every loss, any one risk | 100% of \$7 million excess of \$3 million each and every loss, any |

| Type of Contract | Reinsurer's Name | Company's Retention | Reinsurer's Maximum Limits |
|--|--|---|---|
| | Various reinsurers (51.72%) | | one risk |
| Property Per Risk Excess of Loss – 2nd Layer | Lloyds of London (46.88%) Various reinsurers (53.12%) | \$10 million each and every loss, any one risk | 100% of \$40 million excess of \$10 million each and every loss, any one risk |
| Casualty/Workers' Comp. Excess of Loss – 1 st Layer | Lloyds of London (37%) Endurance Specialty Ins. Ltd. (25%) Aspen Insurance UK Limited (25%) Various reinsurers (13%) | \$10 million each occurrence | 100% of \$15 million excess of \$10 million each occurrence. |
| Casualty/Workers' Comp. Excess of Loss – 2nd Layer | Lloyds of London (47%) Endurance Specialty Ins. Ltd. (25%) Aspen Insurance UK Limited (17%) Various reinsurers (11%) | \$25 million each occurrence | 100% of \$25 million excess of \$25 million each occurrence. |
| Casualty/Workers' Comp. Excess of Loss – 3 rd Layer | Lloyds of London (18.5%) Endurance Specialty Ins. Ltd. (25%) Aspen Insurance UK Limited (20%) Various reinsurers (6.5%) | \$50 million each occurrence, plus 30% of \$50 million excess | 70% of \$50 million excess of \$50 million each occurrence. For Workers' Comp. portion only an additional 30% is covered under the following CAT XOL treaty. |
| Workers' Compensation Catastrophic Excess of Loss | AXA RE (20%) Flagstone Reinsurance Limited (10%) | \$50 million each occurrence | 30% of \$50 million excess of \$50 million each occurrence |

As of December 31, 2006, reinsurance recoverables for all ceded reinsurance totaled \$3.4 billion or 620% of surplus as regards policyholders. Of the reinsurance recoverables 97.7% were from admitted affiliates resulting from the pooling arrangement.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2006

Underwriting and Investment Exhibit for the Year Ended December 31, 2006

Reconciliation of Surplus as Regards Policyholders
from December 31, 2003 through December 31, 2006

Statement of Financial Condition
as of December 31, 2006

| <u>Assets</u> | <u>Ledger and Nonledger Assets</u> | <u>Assets Not Admitted</u> | <u>Net Admitted Assets</u> | <u>Note</u> |
|---|--|--------------------------------|--------------------------------|-------------|
| Bonds | \$ 905,495,941 | \$ | \$ 905,495,941 | |
| Common stocks | 381,544,124 | | 381,544,124 | |
| Real estate: | | | | |
| Properties occupied by the company | 1,365,408 | | 1,365,408 | |
| Properties held for production of income | 90,441 | | 90,441 | |
| Cash and short-term investments | 165,222,977 | | 165,222,977 | |
| Aggregate write-ins for invested assets | 82,945,449 | | 82,945,449 | |
| Investment income due and accrued | 10,826,474 | | 10,826,474 | |
| Premiums and considerations: | | | | |
| Uncollected premiums and agents' balances in the course of collection | 70,813,600 | 7,511,235 | 63,302,365 | |
| Deferred premiums, agents' balances and installments booked but deferred and not yet due | 237,812,967 | | 237,812,967 | |
| Accrued retrospective premiums | 552,219 | | 552,219 | |
| Amounts recoverable from reinsurers | 151,954,255 | | 151,954,255 | |
| Current federal and foreign income tax recoverable | 7,500,000 | | 7,500,000 | |
| Net deferred tax asset | 48,773,788 | 11,262,974 | 37,510,814 | |
| Guaranty funds receivable or on deposit | 1,655,977 | | 1,655,977 | |
| Aggregate write-ins for other than invested assets | <u>15,256,434</u> | <u></u> | <u>15,256,434</u> | |
| Total assets | <u>\$2,081,810,054</u> | <u>\$ 18,774,209</u> | <u>\$2,063,035,845</u> | |

Liabilities, Surplus and Other Funds

| | | |
|--|--------------------|-----|
| Losses | \$ 416,070,167 | (1) |
| Reinsurance payable on paid losses and loss adjustment expenses | 118,499,377 | |
| Loss adjustment expenses | 120,044,873 | (1) |
| Taxes, licenses and fees | 6,581,142 | |
| Current federal and foreign income taxes | 15,842,347 | |
| Unearned premiums | 347,071,159 | |
| Advance premium | 8,335,610 | |
| Dividends declared and unpaid: Policyholders | 225,000 | |
| Ceded reinsurance premiums payable | 201,195,994 | |
| Funds held by company under reinsurance treaties | 2,270,973 | |
| Amounts withheld or retained by company for account of others | 35,348,144 | |
| Provision for reinsurance | 1,906,460 | |
| Payable to parent, subsidiaries and affiliates | 126,443,742 | |
| Aggregate write-ins for liabilities | <u>119,449,387</u> | |
| Total liabilities | 1,519,284,375 | |

| | | |
|--|--------------------|------------------------|
| Surplus notes | \$ 200,330,050 | |
| Unassigned funds (surplus) | <u>343,421,420</u> | |
| Surplus as regards policyholders | | <u>543,751,470</u> |
| Total liabilities, surplus and other funds | | <u>\$2,063,035,845</u> |

Underwriting and Investment Exhibit
for the Year Ended December 31, 2006

Statement of Income

Underwriting Income

| | | |
|---|----------------|--------------------|
| Premiums earned | | \$ 854,316,684 |
| Deductions: | | |
| Losses incurred | \$ 475,094,529 | |
| Loss expenses incurred | 98,067,094 | |
| Other underwriting expenses incurred | 247,896,043 | |
| Aggregate write-ins for underwriting deductions | <u>2</u> | |
| Total underwriting deductions | | <u>821,057,668</u> |
| Net underwriting gain | | 33,259,016 |

Investment Income

| | | |
|------------------------------|------------------|------------|
| Net investment income earned | \$ 43,078,269 | |
| Net realized capital losses | <u>(406,250)</u> | |
| Net investment gain | | 42,672,019 |

Other Income

| | | |
|--|--------------------|----------------------|
| Net loss from agents' or premium balances charged off | \$ (5,294,983) | |
| Finance and service charges not included in premiums | 1,937,728 | |
| Aggregate write-ins for miscellaneous loss | <u>(2,536,889)</u> | |
| Total other loss | | <u>(5,894,144)</u> |
| Net income before dividends to policyholders, after capital tax gains and before all other federal and foreign income taxes | | 70,036,891 |
| Dividends to policyholders | | 390,251 |
| Federal and foreign income taxes incurred | | <u>24,503,809</u> |
| Net income | | <u>\$ 45,142,831</u> |

Capital and Surplus Account

| | | |
|---|--------------------|-----------------------|
| Surplus as regards policyholders, December 31, 2005 | | \$ 456,775,919 |
| Net income | \$ 45,142,831 | |
| Change in net unrealized capital gains | 38,180,006 | |
| Change in net deferred income tax | (5,628,734) | |
| Change in nonadmitted assets | 10,029,817 | |
| Change in provision for reinsurance | 4,975,913 | |
| Aggregate write-ins for losses in surplus | <u>(5,724,282)</u> | |
| Change in surplus as regards policyholders | | <u>86,975,551</u> |
| Surplus as regards policyholders, December 31, 2006 | | <u>\$ 543,751,470</u> |

Reconciliation of Surplus as Regards Policyholders
from December 31, 2003 through December 31, 2006

| | | | |
|--|-----------------------------|----------------------------|-----------------------|
| Surplus as regards policyholders, December 31, 2003, per Examination | | | \$ 195,055,425 |
| | <u>Gain in Surplus</u> | <u>Loss in Surplus</u> | |
| Net income | \$ 167,059,459 | \$ | |
| Change in net unrealized capital gains | 135,761,431 | | |
| Change in net deferred income tax | 11,305,172 | | |
| Change in nonadmitted assets | 37,960,874 | | |
| Change in provision for reinsurance | 141,312 | | |
| Aggregate write-ins for losses in surplus | <u> </u> | <u>3,532,203</u> | |
| Totals | <u>\$ 352,228,248</u> | <u>\$ 3,532,203</u> | |
| Net change in surplus as regards policyholders for the examination | | | <u>348,696,045</u> |
| Surplus as regards policyholders, December 31, 2006, per Examination | | | <u>\$ 543,751,470</u> |

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses

FIRE was directed by the California Department of Insurance (CDI), under California Insurance Code Section 733(g), to retain the American Actuarial Consulting Group, LLC, (AACG) for the purpose of assisting this examination in determining the reasonableness of FIRE's loss and loss adjustment expense reserves. Because the business of the Farmers property and casualty companies was pooled, it was necessary to review the losses on a group-wide basis. Based on the analysis by AACG and the review of their work by a Casualty Actuary from the CDI, FIRE's December 31, 2006 reserves for losses and loss adjustment expenses were determined to be reasonably stated and have been accepted for purposes of this examination.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Management and Control: - Managed Care Services Agreement (Page 122): Zurich Services Corporation, an affiliate, provided certain bill review and medical management services for FIRE's workers' compensation claims. It is recommended that FIRE submit the managed care services agreement to the California Department of Insurance (CDI) for approval pursuant to CIC Section 1215.5.

Previous Report of Examination

Contingent Liabilities (Page 2): Based on discussions with FIRE's attorneys (and the limited review of public domain documents obtained), the examiners were able to obtain an understanding of the volume and range of "class action either claims-related or non-claims-related" lawsuits that the Farmers property & casualty group appeared to be exposed to. However, due to the constraints evident in FIRE limiting the examiners' access only to "public domain" documents or attorney

discussion, a sufficiently complete understanding of its contingent liability exposure was not practical or accomplished. The current examination's review of legal data/documents was limited to "public-domain" only, similar to that of the previous examination.

Common Stocks (Page 24): The carrying value of the common stock of certain pooled subsidiaries of Fire were reduced by their participation in the higher level of loss and loss adjustment expense reserves determined on a group-wide basis by CDI actuaries, and for their pooled share of the accrual of liabilities for the Bell and MDL cases. These reductions in the carrying value of common stocks owned by FIRE totaled \$71,271,532. The December 31, 2006 carrying values of common stocks in pooled subsidiaries owned by FIRE were accepted as reasonable for the current examination.

Federal and Foreign Income Tax Recoverable (Page 25): The examination increased the amount of federal income tax recoverable by \$26,736,338. This was the result of accruing for the tax effect of the higher level of net loss and loss adjustment expense reserves, and the accrual of the Bell and MDL cases, as recorded in the prior examination report. This tax effect amount appeared to qualify for treatment as a Net Operating Loss (NOL) carryback. The amount reported by FIRE for Federal and Foreign Income Tax Recoverable was accepted as reasonable for this examination.

Losses and Loss Adjustment Expenses (Page 27): Based upon an independent actuarial review, FIRE's net loss and loss adjustment expense reserves as of December 31, 2003 were determined to be \$67,025,000 deficient and were adjusted for purposes of the examination. Current carried net loss and loss adjustment expense reserves appeared adequate.

Aggregate Write-Ins for Liabilities (Page 28): The amount of "aggregate write-ins for liabilities" per the examination is \$14,760,049 greater than the FIRE stated amount. The current balance carried in aggregate write-ins for liabilities was accepted as reasonable.

ACKNOWLEDGEMENT

The courtesy and cooperation extended by FIRE's officers and employees during the course of this examination are hereby acknowledged.

Respectfully submitted,

/S/

Gary W. McMurray, CFE
Examiner-In-Charge
Contract Insurance Examiner
Department of Insurance